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Quarterly
ECONOMIC
Commentary

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Quarterly ECONOMIC Commentary

***** CONTENTS*****

Page

I	OUTLOOK AND APPRAISAL	Brian Ashcroft
	THE ECONOMIC BACKGROUND	
1	The international environment	Kenneth Low
2	The UK economy	Brian Ashcroft
4	UK labour market	Kim Swales
	THE SCOTTISH ECONOMY	
6	Short-term forecasts	Ya Ping Yin
6	Deloitte & Touche Scottish Chambers' Business Survey	Eleanor Malloy
8	Construction	Eleanor Malloy
9	Energy	Kenneth Low
10	Food, Drink and Tobacco	Stewart Dunlop
11	Electronics	Gary Gillespie
13	Chemicals	Sarah Le Tissier
14	Textiles, Leather, Clothing and Footwear	Stewart Dunlop
14	Paper, Printing and Publishing	Gary Gillespie
15	Mechanical Engineering	Ya Ping Yin
16	Distribution	Eleanor Malloy
17	Transport	Kenneth Low
19	REGIONAL REVIEW	Kenneth Low
26	THE LABOUR MARKET	Peter McGregor
27	Business Survey results	Cliff Lockyer
	ECONOMIC PERSPECTIVES	
35	Import Substitution and the Demand for Skilled Labour in Scotland	I H McNicoll and M Foley
40	Stocking The Glen: The Relationship Between Original Equipment Manufacturers And The Scottish Supply Base	Dr James McCalman
	EDITORS	Brian Ashcroft, Eleanor Malloy and Sarah Le Tissier
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|Outlook AND Appraisal

The latest Scottish Office data for production and construction in Scotland indicate that in the second quarter of this year the production sector out performed its UK counterpart while Scottish construction did less well. Output in the production industries rose by 2.5% in Scotland compared to an increase of 0.6% in the UK. Construction output, on the other hand, fell by 0.6% in Scotland but rose by 0.6% in the UK. When production and construction are taken together and oil and gas removed, the sector in Scotland increased its output by 1.9% compared with an increase of only 0.7% in the UK. Within production, Scottish manufacturing output grew by 2.6% while manufacturing in the UK could only expand by 0.3%. Of the 11 manufacturing sub-sectors for which data are reported, only two sectors in Scotland, Chemicals and Food & Tobacco, performed worse than their UK counterparts in the second quarter.

When the data are reviewed over the year to the second quarter 1997, Scotland's stronger performance in production and weaker outturn in construction continues. Production and manufacturing grew by 6.5% and 7% respectively in Scotland compared to rates of 1.3% and 1.2% in the UK. The UK construction sector, however, grew by 3.4% over the period, considerably faster than the 0.4% growth achieved in the sector in Scotland. Overall, the production and construction sectors, excluding oil and gas, raised their output over the year by 5.2% in

Scotland and 1.6% in the UK. Again of the 11 manufacturing sub-sectors, only three sectors in Scotland, Food & Tobacco, Drink and Transport Equipment, performed worse than their UK counterparts over the year.

Yet despite the recent relative improvement in the performance of Scotland's manufacturing industries and particularly non-electronics manufacturing, the general weakness evident during the recovery period still remains. During the five years since the second quarter of 1992 output in manufacturing in Scotland has grown by 28.4% compared with an 11.3% expansion in the UK. However, once the performance of the electronics sector is removed from the manufacturing data, non-electronics manufacturing in Scotland is seen to have *contracted* by 2.7% in Scotland compared to growth of 7.9% in the UK. Nothing could provide a clearer indication of how Scotland's economy has come to rely on electronics and inward investment. Of the 10 non-electronics manufacturing sectors for which data are reported only three, Refined Petrol & Nuclear Fuel, Chemicals and Metals, have grown overall more quickly than their UK counterparts during the recovery period. The presence of the largely overseas-owned electronics sector in Scotland has effectively prevented the emergence of a deficit of 10.6% points in Scottish manufacturing growth. Instead, Scottish manufacturing growth out performed the growth of UK manufacturing by 17.1 percentage points.

It is against this background that any wider economic developments affecting the electronics sector and inward investment need to be viewed with concern. The most recent threat to the sector in Scotland, as reported in the **Electronics** section of this **Commentary**, was the fear that the currency crisis in Asia would affect the flow of inward investment to Scotland from this region. Of most immediate concern, was the speculation that the Hyundai group would delay its £3 billion investment in two semiconductor plants in Fife, threatening the realisation of the expected 2,000 jobs. However, it appears from recent reports that the planned investment will go ahead on schedule, despite pressure from the South Korean government for the company to reduce its external debt.

Government Expenditure and Revenue in Scotland

November saw the publication of *Government Expenditure and Revenue in Scotland 1995-*

1996. The Report, prepared by the Economic Advice and Statistics Division (EAS) of the Scottish Office Education and Industry Department, provides the latest estimates for expenditures, revenues and the General Government Borrowing Requirement (GGBR), or "fiscal deficit", attributable to Scotland. In our view, the Report applies the best available methodology to the estimate of expenditures and revenues, although as the Report itself recognises, the calculations, especially the "fiscal deficit", are subject to imprecision. The Report cautions that the GGBR or "deficit" estimates should "be regarded as indicative rather than precise" (p.1).

The EAS team estimate that in fiscal year 1995-1996, Scotland's "fiscal deficit" ranged from £7.4 billion, when North Sea revenues and privatisation proceeds are excluded, to £4.9 billion, when privatisation proceeds are included and *all* the estimated North Sea revenues are allocated to Scotland. Expressing the estimates as a proportion of the appropriate measure of Scotland's GDP, results in a deficit equivalent to 12.5% of GDP for the former measure and 6.75% for the latter. These figures are to be compared with the equivalent UK deficit/GDP ratio of 5.25%. The Report also shows that throughout the 1990s Scotland has had a substantial "fiscal deficit". However, it is worth noting that it is probable that the application of the EAS methodology to the first half of 1980s would reveal a Scottish "fiscal surplus", when North Sea revenues are included, due to the significantly greater scale of the oil revenues in that period.

In a unitary state, even with devolved parliaments, the concept of a "fiscal deficit" at the sub-state level has little meaning. However, at a more fundamental economic level the apparent existence of a structural "fiscal deficit", when the windfall gain provided by North Sea revenues is excluded, is one indication of the historic under performance of the Scottish economy relative to the UK as a whole. The weaker performance of the Scottish economy this century has led to a significant net out migration of population, averaging 250,000 each decade. Many of these migrant Scots went to other parts of the UK thus contributing to the performance of the rest of the UK economy and the tax revenues generated for the Exchequer, while at the same time eroding the tax base in Scotland. Slower economic growth has led to a higher average rate of unemployment and social deprivation in Scotland thus raising the need for transfer payments to Scotland from the tax revenue

generated (in part by migrant Scots) elsewhere in the UK.

Moreover, Scotland is also a high-saving country which when combined with the relatively slow growth of the economy has resulted in private sector savings exceeding domestic investment. As a matter of accounting identities excess saving has to be balanced by either a public sector "fiscal deficit" and/or a balance of payments surplus. The upshot of all this is that the Scottish "fiscal deficit" is probably a reflection of the relatively weaker performance of the Scottish economy and the high saving propensity of Scottish residents. While there may be some room for debate as to whether public spending per capita in Scotland is above "need" this does not detract from the point that concern and debate about Scotland's "fiscal deficit" is sterile and fundamentally misplaced. It is simply a symptom of Scotland's slower rate of economic growth.

Of much greater importance is the question how to improve Scotland's economic performance relative to the UK and other modern economies. The focus of concern should therefore be on the performance of the private sector and not the state of Scotland's public finances. The key issues here are how to change private sector saving and particularly investment behaviour in Scotland. Investment needs to be raised through increased new firm formation, product and process innovation and the exploitation of new markets. Through the creation of business confidence and new investment, Scottish savings are more likely to be channelled into opportunities available in Scotland rather than elsewhere. And with increased economic growth the issue of Scotland's "fiscal deficit" will simply fade away.

Outlook

We take the view that the Scottish economy will follow the UK economy next year as the rate of economic growth slows. As noted in the **UK Economy** section, all of the 46 forecasters surveyed by the Treasury predict that UK growth will be slower next year, with the average expectation being that the GDP growth rate will fall from 3.4% in 1997 to 2.5% in 1998. This prediction is reinforced following the further tightening of the base rate in early November to 7.25%. However, consumers' expenditure is still growing strongly despite the downward 'blip' in retail sales volumes in September – attributed to the

loss of part of trading on Saturday September 6th, due to the funeral of Diana Princess of Wales. In addition, both private investment and exports are growing strongly, while the weak growth of public expenditure and the strong growth of imports have served to dampen the demand for domestic goods and services.

Nevertheless, the consensus view that the economy is slowing down reflects a belief that the strong growth in consumers' expenditure and in exports is a temporary phenomenon. Thus it is believed that spending from the windfall gains arising from the demutualisation of some of the building societies is soon likely to be exhausted, while export growth is finally expected to slow in the face of the sustained high level of sterling. Accordingly, we do not expect GDP to grow by more than 2.5% in Scotland next year, while our forecast for manufacturing output is that growth will be slower this year (1997) than last at around 4% compared with 5.3% in 1996. The growth of manufacturing output is expected to slow further next year as export demand moderates and the growth of consumer spending slows.

10 December 1997